No. 8166

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

PACIFIC EMPLOYERS INSURANCE COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF ON BEHALF OF AMERICAN AUTOMOBILE INSURANCE COMPANY.
BERNHARD KNOLLENBERG, AMICUS CURIAE.

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The Petitioner is here, in effect, asserting the right to take as a deduction, in computing its net taxable income for 1930, a reserve for losses, computed in accordance with the statutory requirement of the State of California, without reference to whether this amount actually represents the best available estimate of what it will ultimately be called upon to pay on account of losses incurred but unpaid during its fiscal year ended December 31, 1930.

The Commissioner of Internal Revenue held that the petitioner was entitled to deduct only the amount

which it claimed as a deduction for losses in its original return, which deduction represented the aggregate of the estimates of losses submitted by the Company's Claim Examiners. The Board sustained the Commissioner's ruling.

We have no fault to find with this decision as such. The fact that the California law may require a certain reserve for losses has no bearing on the proper allowance for losses under the federal income tax law. The only evidence before the Commissioner and the Board as to the amount of losses incurred and unpaid at the close of the year 1930 was the amount computed by the Company's Claim Examiners; in fact, the Company stipulated the amount was correct. *Under these facts,* the Board properly declined to allow any larger deduction.

The Bureau of Internal Revenue has, however, interpreted the Board's decision and opinion in the present case as laying down an inflexible rule that the deductible losses of an insurance company, for federal income tax purposes, must be determined solely on the basis of the estimate of losses submitted by the Company's Claim Examiners.* This position, as we shall later show, is wholly unsound and we believe that the Board did not intend to establish or approve any such rule. But certain statements in the Board's opinion tend to give some basis for the Bureau's position, and the only way to avoid further confusion in the matter is for this Court to make clear, in its opinion on this

*This statement does not apply to life insurance companies or to mutual non-life companies. In the case of such companies, a wholly different method of computing the net taxable income is applicable.

appeal, that it does not recognize or approve the rule adopted by the Bureau.

The unsoundness of this rule will be apparent from a consideration of (1) the pertinent provisions of the federal tax statute; (2) the business facts in the light of which these statutory provisions were enacted, and (3) the decision of the United States Circuit Court of Appeals for the Second Circuit in *Ocean Accident & Guarantee Corporation, Ltd. v. Commissioner,* 47 F. (2d) 582 (1931).

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1. STATUTORY PROVISIONS.

The provisions of the Revenue Act of 1928 (and corresponding provisions of subsequent Acts) are as follows:

> "Sec. 204. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.
>
> (a) Imposition of tax.—In lieu of the tax imposed by section 13 of this title, there shall be levied, collected, and paid for each taxable year upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:
>
> *   *   *   *   *   *   *
>
> (c) Deductions allowed.—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:
>
> *   *   *   *   *   *   *
>
> (4) Losses incurred as defined in subsection (b) (6) of this section;
>
> *   *   *   *   *   *   *

(b) Definition of income, etc.—In the case of an insurance company subject to the tax imposed by this section——

*   *   *   *   *   *   *

(6) LOSSES INCURRED.—'Losses incurred' means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all *unpaid losses outstanding at the end of the taxable year* and deduct unpaid losses outstanding at the end of the preceding taxable year." (Italics ours.)

It will be seen from the above that there is nothing in the statute which prescribes or intimates that the *"unpaid losses outstanding at the end of the taxable year"* to be allowed as an accrued deduction, shall be computed by any specific method. The natural inference is, therefore, that Congress intended that the accrual should be computed by such method as the Company has found by experience will produce the highest degree of accuracy, in line with the general rule that a taxpayer's account, for tax purposes, shall be kept in such manner as "to clearly reflect the income". (Sections 41 and 43 of the 1928 Act.) The Commissioner has no power to read into the law limitations which Congress itself has not imposed.

Morrill v. Jones, 106 U. S. 466.

2. THE BUSINESS FACTS IN THE LIGHT OF WHICH SECTION 204 WAS ENACTED.

If it were customary for insurance companies (other than life or mutual companies) to compute accrued losses by simply adding the estimates of losses submitted by the Company's Claim Examiners, there might be conceivable justification for the Bureau to read into the statute an implication that the deduction for unpaid losses must be computed in accordance with this customary practice. But the Bureau has never contended and could not contend that there is any such custom, because the fact is that, while the estimates of losses submitted by the Company's Claim Examiners may be given weight in arriving at the amount of losses to be accrued, the established practice is to take into account other data as well.

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3. THE OCEAN ACCIDENT & GUARANTEE CORPORATION, LTD. CASE.

In its opinion, the Board, referring to the decision in the *Ocean* case (47 F. (2d) 582) said (Transcript of Record pp. 38-39):

> "The amount claimed in the return filed by the petitioner and allowed by the respondent was the result of a careful calculation based on the claims filed with it. An examiner investigated each claim, took into consideration a number of factors, listed in the stipulation, which might affect the amount of petitioner's liability and arrived at a sum that in his opinion the petitioner would be required to pay. These sums were totaled and the totals were listed by petitioner as the 'unpaid

losses' and approved by the respondent. In a case analogous on the facts, but arising under the different statutory provisions of the Revenue Act of 1918, deductions for losses calculated as in this case were allowed as 'accrued but unpaid losses'. Ocean Accident & Guarantee Corporation, Ltd. v. Commissioner, 47 Fed. (2d) 582."

This statement in the Board's opinion is what the Bureau principally relies upon, in support of its contention that the deduction for unpaid losses is necessarily limited to the aggregate of the estimate of losses submitted by the Company's Claim Examiners. We submit that the decision in the *Ocean* case does not in the least tend to support the position that insurance companies must use one particular method, namely, a simple adding together of the estimates submitted by its Claim Examiners, in computing their allowable deductions for unpaid losses; but, on the contrary, supports a diametrically opposite conclusion. The facts, as set forth in the Court's preliminary statement of facts, and supplemented by a statement in its opinion, at page 583, are as follows:

"When an accident or injury covered by such a policy is reported to the petitioner, its practice is to have an investigation thereof instituted by its claim department, as a result of which an estimate of the probable amount of liability under such policy is entered upon a record card. The estimates so set up are constantly revised as reports are received on individual cases, and the total of all such cases are summarized by the petitioner's statistical department. Petitioner's experience based on actual payments subsequently

made showed that the estimated amounts for alleged losses sustained but unpaid were within 1 7/40 per cent of being accurate."

* * * * * * *

"The dispute is whether the petitioner may also have a third deduction, namely, the estimated amount of its liability for policy losses accrued, but not paid, within the year; and, since subsequent experience proved that its estimates of accrued but unpaid losses were 1 7/40 per cent too high, petitioner has made a corresponding reduction in the amount of the deduction it is claiming for each of the years in question."

On the basis of these facts, the Court approved the Company's deduction for losses; saying (p. 585):

> "The Board made no finding that the method employed did not reflect net income. On the contrary, it found that the method used by petitioner was generally used by casualty insurance companies to determine the amount of their losses in any year, and that the estimates kept by petitioner were considered necessary to determine its financial condition and to fix its premium rates. Experience showed the extraordinary accuracy of such estimates. Accordingly we think the Board erred in holding that the estimates of accrued but unpaid policy losses were too uncertain to be deductible under section 234(a) (10)."

It is evident from the above that the Court, far from holding that the estimates of the Claim Examiners must be regarded as the ultimate criterion for computing the accrued losses to be deducted, ex-

plicitly approved the Company's practice of adjusting the estimates of the Claim Examiners by reference to other data coming before its statistical department, and particularly by the Company's own experience record.

Assuming that it affirms the Board's decision, this Court can and will prevent a great amount of unnecessary confusion and expense by making clear, in its opinion in the present case, that the Revenue Act itself does not provide that the accrual for unpaid losses of insurance companies must be determined by any one method apart from the general rule that a taxpayer must keep his accounts in such manner as clearly to reflect his net income, and that this Court does not approve of the Board's opinion in the present case, in so far as that opinion is open to the construction that such losses must be computed exclusively on the basis of the reports submitted by the insurance companies' Claim Examiners.

Meaning of "Reserve".

In its opinion in this case, the Board said (Transcript of Record p. 38):

> "Thus, the amount now claimed by the petitioner appears to be essentially a reserve, which is not available to this type of insurance company as a deduction in computing net income."

The Bureau of Internal Revenue has interpreted this statement to mean that insurance companies other than life or mutual companies are not entitled to deduct any reserve, even a reserve for incurred but

unpaid losses. This interpretation of the Board's statement is clearly unsound as established by the fact that the so-called "accrued" losses which the Board itself approved in the present case were, strictly speaking, a "reserve", i. e., an *estimate* of the aggregate of unpaid losses as distinguished from the total of agreed or adjudicated losses still unpaid, which would be in the nature of accounts payable.

Presumably the Board merely intended to point out by its reference to reserves that companies of the type of Pacific Employers Insurance Company are not entitled to a deduction generally for "reserve funds required by law", within the meaning of Section 202(b) of the Revenue Act of 1934; additions to reserves of this type (including reserves for death or accidents in the future to those covered by insurance contracts in force at the close of the fiscal year) being deductible, under the terms of the statute, only by life insurance or mutual companies.

It would be instructive to the Bureau if this Court would take pains to point out in its opinion in the present case that this language could not have been intended to refer to all reserves and that certain reserves, namely, reserves for depreciation and reserves for incurred but unpaid losses are allowed by the statute as a deduction to insurance companies which are neither life nor mutual companies.

Dated, January 27, 1937.

Respectfully submitted,

BERNHARD KNOLLENBERG,

Amicus Curiae.